

REPORT OF EXAMINATION
OF THE
STERLING CASUALTY INSURANCE COMPANY
AS OF
DECEMBER 31, 2002

TABLE OF CONTENTS

	<u>PAGE</u>
SCOPE OF EXAMINATION.....	1
SUMMARY OF SIGNIFICANT FINDINGS	2
Common Stocks	2
Risk-Based Capital.....	2
Capital	3
Rating	3
COMPANY HISTORY	3
MANAGEMENT AND CONTROL:	4
Operating Lease	5
Management Agreements	5
Agency Agreements.....	7
CORPORATE RECORDS	8
TERRITORY AND PLAN OF OPERATION	8
GROWTH OF COMPANY	9
REINSURANCE.....	10
Assumed.....	10
Ceded	10
ACCOUNTS AND RECORDS	11
FINANCIAL STATEMENTS:.....	12
Statement of Financial Condition as of December 31, 2002	13
Underwriting and Investment Exhibit for the Year Ended December 31, 2002.....	14
Reconciliation of Surplus as Regards Policyholders from December 31, 1998 through December 31, 2002.....	15
COMMENTS ON FINANCIAL STATEMENT ITEMS:.....	16
Bonds, Preferred and Common Stocks, and Cash and Short-Term Investments.....	16
Premiums and Agents' Balances in Course of Collection	17
Federal Income Tax Recoverable and Receivable from Parent.....	18
Losses and Loss Adjustment Expenses	18
Surplus Note	18
SUMMARY OF COMMENTS AND RECOMMENDATIONS	18
Current Report of Examination.....	18
Previous Report of Examination.....	20
ACKNOWLEDGEMENT	21

Los Angeles, California
March 12, 2004

Honorable John Garamendi
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Commissioner:

Pursuant to your instructions, an examination was made of the

STERLING CASUALTY INSURANCE COMPANY

(hereinafter also referred to as the Company) at its statutory home office located at 20351 Acacia Street, Newport Beach, California 92660.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 1998. This examination covers the period from January 1, 1999 through December 31, 2002. The examination included a review of the Company's practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, and an evaluation of the assets and a determination of liabilities as of December 31, 2002, as deemed necessary under the circumstances.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans; business in force by states; loss experience; and sales and advertising.

SUMMARY OF SIGNIFICANT FINDINGS

Common Stocks

Historically, the Company has invested primarily in common stocks. During the examination period, the Company experienced both a significant gain, then loss in the market value of its common stock holdings. Technology stocks were a significant component of the Company's common stock portfolio. In addition, as the equity market began its decline in early 2000, the Company was also heavily involved in options ("puts") in a declining market which compounded its overall losses. The Company's common stock holdings are highlighted as follows:

- As of December 31, 1999, common stocks had a cost basis of \$18.1 million and unrealized capital gains of \$22 million, for a book value of \$40.1 million;
- During the first quarter of 2000, common stocks had a cost basis of \$28.2 million and unrealized capital gains of \$26.2 million, for a book value of \$ 54.4 million (this period was the highest value for the portfolio);
- As of December 31, 2000, common stocks had a cost basis of \$27.6 million and unrealized capital gains of \$800,000, for a book value of \$28. 4 million (the Company sustained a loss of more than \$25 million in unrealized capital gains);
- As of December 31, 2001, common stocks had a cost basis of \$31.3 million and unrealized capital losses of \$500,000, for a book value of \$30.8 million;
- As of December 31, 2002, common stock had a cost basis of \$27.3 million and unrealized capital losses of \$10.3 million, for a book value of \$17 million.

In summary, during the examination period, the Company has incurred unrealized capital losses in its common stock portfolio of over \$26 million, even more taking into account losses from the first quarter of 2000, when its portfolio was at its peak value. This has been the main factor that has adversely impacted the Company's surplus as regards policyholders during the examination period.

Risk-Based Capital

At December 31, 2002, the Company filed a Risk-Based Capital (RBC) report that reported the ratio of the Company's total adjusted capital to its authorized control level risk-based capital, at 163%. This RBC ratio classified the Company at the "Company Action Level" pursuant to California Insurance Code (CIC) Section 739.3. Under this CIC Section, the Company is required to submit a RBC Plan,

along with pro forma financial statements. On April 7, 2003, the Company submitted the RBC Plan in compliance with the CIC Section 739.3. The RBC was reviewed and deemed adequate.

At December 31, 2003, the Company filed a RBC report that reported the ratio of the Company's total adjusted capital to its authorized control level risk-based capital, at 399%. This RBC ratio classified the Company at the "No Action level" pursuant to California Insurance Code (CIC) Section 739.3.

Capital

During 2002, the Company received two capital infusions. One contribution was in the form of a surplus note for \$1.4 million, and is discussed in the comments on financial statement items. The other amount was a \$1.9 million refund of management fees from H&H Agency, Inc. as discussed in the comments under management agreements.

Rating

In December 2002, A.M. Best downgraded the Company's rating to a "D." In May 2003, A. M. Best upgraded the Company's rating to a "C".

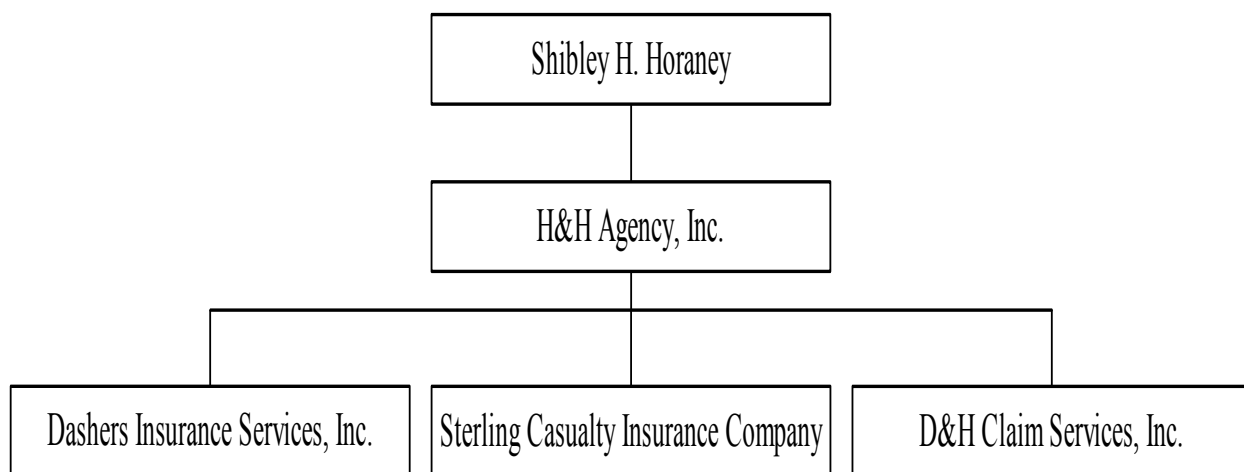
COMPANY HISTORY

On December 3, 1999, the California Department of Insurance issued a stock permit to the Company authorizing it to increase the par value of its common stock from \$25 to \$75 per share. With 20,000 shares issued and outstanding, the transaction increased the Company's capital stock account from \$500,000 to \$1.5 million. In December 1999, the Company accounted for the transaction by transferring \$1 million from its unassigned funds to its capital stock account.

The Company paid a dividend of \$1 million to its immediate parent, H&H Agency, Inc. during 2000.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system and is wholly-owned by H&H Agency, Inc. The ultimate controlling person is Mr. Shibley H. Horaney. The following organizational chart depicts the inter-relationship of the Company within the holding company system: (All ownership is 100%)



Management of the Company is vested in a five-member board of directors elected annually by the sole shareholder of H&H Agency, Inc., Mr. Shibley H. Horaney. A listing of the members of the board and principal officers serving on December 31, 2002 follows:

Directors

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
Shibley H. Horaney Newport Beach, California	President H&H Agency, Inc.
Charles T. McConnell Newport Beach, California	Senior Vice President Sterling Casualty Insurance Company
Jean A. Reep, CPA	Certified Public Accountant

<u>Name and Residence</u>	<u>Principal Business Affiliation</u>
North Hollywood, California	
M. Dean Rosenberger, CPA Pasadena, California	Certified Public Accountant
Charles J. Williamson Costa Mesa, California	Vice President and Treasurer Sterling Casualty Insurance Company

Principal Officers

<u>Name</u>	<u>Title</u>
Shibley H. Horaney	President and Chief Executive Officer
Charles T. McConnell	Senior Vice President
Charles J. Williamson	Vice President and Treasurer

Operating Lease

On January 1, 1996, the Company signed a ten-year operating lease for its current office space from the sole shareholder of its parent, Mr. Shibley Horaney. The lease commitments are \$17,000 per month. Pursuant to California Insurance Code (CIC) Section 1101, transactions with officers or employees that have a personal interest require special exemption. The Company did not file for a CIC Section 1101 exemption prior to entering into the operating lease. It is recommended that the Company file for an exemption with the California Department of Insurance (CDI). It should be noted that this recommendation was made in the previous examination. Since 1995, the Company has continued to disregard this recommendation from the CDI.

Management Agreements

H&H Agency, Inc. (H&H): The Company has no employees and all services are provided for by employees of H&H, which also acts as the Company's Managing General Agent under the terms of a management agreement that has been in place since July 1, 1995. Under the terms of the agreement, the Company is responsible for direct payment of losses, allocated loss adjustment expenses, management fees, rent, legal fees, premium tax, audit fees, and other investment expenses.

H&H provides certain executive and professional services, the most significant of which are the marketing, production, and underwriting of insurance policies. In exchange for these services, the Company had been annually paying H&H 25% of the Company's net written premiums, and 100% of policy, billing, and other fees. On October 18, 2002, the Management Agreement was amended lowering the management fee to 21%. The amendment was retroactive to January 1, 2002, and resulted in a refund of \$1,910,221 in management fees from H&H to the Company. This management fee refund was deemed a capital infusion from H&H to the Company and the amount was deposited into the Company's operating account on October 18, 2002.

Upon review of the amended 21% management fee, the CDI recommended that the management fee be based on actual cost. On December 2, 2002, the Management Agreement was amended and restated and the terms of the management fee were changed from 21% to an actual cost reimbursement basis. During the course of the examination, the Company performed a cost allocation study in order to estimate and determine what the management fees will compute to on a cost reimbursement basis. The amended management agreement was submitted to and approved by the CDI in December 2002.

H&H, under an agreement with its subproducer and subsidiary, Dashers Insurance Services, Inc. (Dashers), pays Dashers a commission of 17.5% for the business it produces. Dashers retains, as part of its commissions, all related policy and other fees. H&H pays independent producers a 10% to 15% commission on net written premiums produced. The Company paid the following commissions and service fees to H&H during the examination period:

Year	Commissions and Service Fees	Net Earned Premiums	% of Commission and Service Fees to Net Earned Premiums
1999	\$ 7,241,349	\$28,509,488	25%
2000	\$ 6,488,989	\$22,739,032	29%
2001	\$ 9,040,951	\$28,365,787	32%
2002	\$13,481,792	\$77,583,594	17%
Totals	\$36,253,081	\$157,197,901	23%

D&H Claims Services, Inc.: On January 22, 1998, on behalf of the Company, H&H Agency, Inc., contracted with D&H Claims Services, Inc., (D&H), an affiliated company, for claims adjusting and settlement services. Under the terms of this contract, the Company pays D&H a flat fee per claim based on line of coverage. During the examination period, the Company paid D&H a total of \$3,398,439 in claims adjusting and settlement fees.

Agency Agreements

Multi-State Insurance Services, Inc. (Multi-State): Effective December 1, 2001, the Company entered into an agency agreement with Multi-State. Under the agreement, Multi-State has the authority to accept applications and to issue policies on behalf of the Company. As compensation, Multi-State receives: 18% of all policy premiums; a portion of policy fees and billing fees; and 100% of filing fees. During 2002, Multi-State produced \$9.6 million in direct written premiums for the Company. In October 2002, in a effort aimed at slowing its premium growth, the Company directed Multi-State to not issue any new policies.

Freedom National Insurance Services, Inc. (Freedom): Effective August 1, 2001, the Company entered into an agency agreement with Freedom. Under the terms of the agreement, Freedom has the authority to accept applications and to issue policies on behalf of the Company. As compensation, Freedom receives 15% of all policy premiums. During 2002, Freedom produced \$10.3 million in direct written premiums for the Company. In October 2002, in a effort aimed at slowing its premium growth, the Company directed Freedom to not issue any new policies.

Freedom utilizes a third party administrator, Freedom National Adjustment Bureau, Inc. (Freedom Adjustment), to pay claims. Under an agreement effective August 1, 2001 between Freedom Adjustment and the Company, Freedom Adjustment has the authority to pay any claims on policies issued by the Company pursuant to the Freedom agreement. As compensation, Freedom Adjustment is paid a fee of 10.5% of monthly premium collected by Freedom.

CORPORATE RECORDS

California Insurance Code (CIC) Section 735 states that the Company must inform the board members of the receipt of the examination report. The board should be informed of the report, both in the form first formally prepared by the examiners, and in the form as finally settled and officially filed by the commissioner. The board must also enter that fact in the board minutes.

During the review of the board of director's minutes, it was noted that there was no record of the officers informing the board members of the receipt of the examination report filed by the California Department of Insurance in 2000. It is recommended that the Company take the necessary steps to ensure that all future examination reports are submitted to the board, pursuant to CIC Section 735.

TERRITORY AND PLAN OF OPERATION

The Company is authorized to write personal auto liability and physical damage coverage solely in the State of California. Underwriting activities are targeted exclusively toward insuring non-standard risks. The Company currently has two personal automobile insurance programs that are marketed through managing general agents. The Sterling Casualty Combination Liability and Physical Damage program is marketed through its parent, H&H Agency, Inc. and two independent managing general agents, Multi-State Insurance Services, Inc. and Freedom National Insurance Services, Inc.

The Sterling Casualty 'Eagle' program is marketed through Freedom National Insurance Services, Inc. All general agents market the products through independent agencies under a broker agreement. H&H Agency, Inc. also markets the 'Combination' program through an affiliate, Dashers Insurance Services, Inc. (Dashers).

Dashers has 18 sales offices throughout California and accounts for approximately 40% of the Company's written premium production. Premiums written through independent agencies and Dashers are remitted through the appropriate contracted managing general agent. The managing

general agents' in turn, remit premiums to the Company according to the terms of their management agreement with the Company.

The Company seeks to minimize its risk by insuring vehicles and insureds that have minimal exposure. The maximum liability limits offered through the 'Combination' and 'Eagle' programs are \$25,000 bodily injury liability per person/\$50,000 bodily injury per occurrence/\$10,000 property damage. The approach to minimize exposure is also present in the physical damage coverage offered. The "Combination" program will only insure vehicles with a new value less than \$36,000, and the 'Eagle' program will only insure vehicles with a value of \$30,000 or less.

GROWTH OF COMPANY

The sharp equities market decline in recent years adversely affected the value of the Company's assets and its surplus. During the period, the Company's direct premiums written increased from \$30 million in 2001, to \$85 million in 2002. This exponential growth in premiums written coupled with the significant decrease in statutory surplus created a high premiums to surplus ratio in years 2002 and 2003. In October 2002, the Company created a business plan aimed at slowing its premium growth. The plan included:

- Implementing a 13% rate increase effective on November 15, 2002;
- Informing its independent agents, brokers, and its two managing agents, Multi-State Insurance Services, Inc. and Freedom National Insurance Services, Inc., to refrain from selling any new Company policies. These producers were to only issue policy renewals;
- Authorizing its affiliate, Dashers Insurance Services, Inc. to continue selling new and renewal business;

With the above implemented changes, the Company's 2003 direct premiums written was \$70 million.

In April 2003, the Company's producers began selling new policies on a limited basis. On September 1, 2003, the Company implemented another 9% rate increase.

The following schedule reflects the financial position of the Company since the last examination:

(000 omitted)

Year	Admitted Assets	Surplus As Regards Policy-Holders	Net Unrealized Capital Gains or (Losses)	Net Premiums Written	Net Underwriting Gain/(Losses)	Net Income (Loss)
1999	\$ 66,536	\$ 45,076	\$ 7,400	\$ 25,557	\$ 2,018	\$ 4,053
2000	43,997	23,554	(22,150)	22,756	1,607	570
2001	42,975	18,804	(1,081)	30,000	(1,388)	(4,108)
2002*	49,825	7,837	(10,379)	84,947	(2,892)	(3,190)
2003	38,473	11,343	9,197	70,215	2,015	(6,128)

*per examination

REINSURANCE

Assumed

The Company has no reinsurance assumed.

Ceded

On January 1, 2003, the Company entered into a quota share reinsurance agreement with Hannover Ruckversicherungs-Aktiengesellschaft (HRA) whereby the Company cedes 55% of its direct written premium to HRA. The line of coverage is for all policies classified by the Company as Private Passenger Automobile Liability and Private Passenger Automobile Physical Damage. The reinsurer's maximum treaty limits are 55% of incurred losses and loss adjustment expenses on any one policy, any one occurrence. In addition, HRA is not liable for any incurred losses and allocated loss adjustment expenses greater than a maximum incurred loss ratio of 95%.

ACCOUNTS AND RECORDS

Under a management agreement, H&H Agency, Inc. (H&H) and its subproducer and subsidiary, Dashers Insurance Services, Inc. collect premiums and hold the funds in a fiduciary capacity for the Company. A review of these premium trust accounts disclosed the following deficiencies:

- In the year 2002, H&H and Dashers did not reconcile trust bank accounts on a timely basis. Monthly trust bank reconciliations had not been performed in over 4 months. During the course of the examination, reconciliations were brought up to date;
- There was no documentation disclosing that the Company, H&H, and Dashers had ever performed a trust account reconciliation to determine whether the Company's booked premium activity reconciled to the trust funds held by its affiliates. In October 2002, the examiners performed a monthly trust reconciliation that concluded that H&H spent \$230,000 of premium trust funds that belonged to the Company. This deficiency was corrected in November 2002. The Company and H&H should maintain sufficient accounting records to clearly prove its premium trust position;
- Premiums collected by Dashers are not being transferred to H&H in a timely manner. Funds are being transferred to H&H on an "as needed" basis as opposed to the terms of the agreements. Since the Company's management agreement is with H&H and not Dashers, it is imperative that trust funds be transferred to H&H per the terms of the agreements, and not reside with Dashers. This "as needed" practice employed by H&H, also affected the transfer of trust funds from H&H to the Company. Pursuant to its management agreement, H&H shall remit trust funds due the Company on a monthly basis. H&H was not remitting the funds monthly, and at times, holding three months of premium collections. It is recommended that H&H remit the premium funds to the Company on a monthly basis, as stated in its management agreement;
- Although Dasher Insurance Services Inc.'s agents predominantly produce business for the Company under an agreement with H&H, they also sell other insurers' products, and deposit their premiums in some small local trust accounts that also contain Company premiums. Currently, Dashers estimates each insurer's balance within these trust accounts on a percentage basis. It is recommended the Company demand that Dashers segregate such premiums and create internal controls which maintain the integrity of these small local trust accounts.

The verification of the Company's unearned premiums disclosed that the Company maintains policy data detail on its system for all their producers, except Freedom National Insurance Services, Inc. (FNIS). Due to this limitation, FNIS' data could not be validated. It is recommended that the Company obtain policy data detail for FNIS.

In analyzing the Company's direct written premiums for 2001 and 2002, the Company could not provide monthly detailed information, such as monthly policy renewals, or ascertain the certainty of new policy counts for some of their producers. It is recommended that the Company strengthen its accounting controls in tracking policy counts for all of its producers.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2002

Underwriting and Investment Exhibit for the Year Ended December 31, 2002

Reconciliation of Surplus as Regards Policyholders
from December 31, 1998 through December 31, 2002

Reconciliation of Examination Changes as of December 31, 2002

Statement of Financial Condition
as of December 31, 2002

<u>Assets</u>	<u>Ledger and Nonledger Assets</u>	<u>Net Admitted Assets</u>	<u>Note</u>
Bonds	\$ 4,860,473	\$ 4,860,473	(1)
Stocks:			
Preferred Stocks	559,099	559,099	(1)
Common Stocks	16,999,631	16,999,631	(1)
Cash and short-term investments	9,687,567	9,687,567	(1)
Agents' balances or uncollected premiums:			
Premiums and agents' balances in course of collection	16,726,344	16,726,344	(2)
Federal income tax recoverable	288,258	288,258	(3)
Interest, dividends, and real estate income due and accrued	81,128	81,128	
Receivable from parent, subsidiaries and affiliates	<u>622,233</u>	<u>622,233</u>	(3)
Total assets	<u>\$ 49,824,733</u>	<u>\$ 49,824,733</u>	
<u>Liabilities, Surplus and Other Funds</u>			
Losses		\$ 26,117,381	(4)
Loss adjustment expenses		3,035,080	(4)
Other expenses		11,711	
Taxes, licenses and fees		975,122	
Unearned premiums		10,789,076	
Payable for securities		1,148,221	
Federal and foreign income taxes		<u>(88,883)</u>	
Total liabilities		41,987,708	
Common capital stock	\$ 1,500,000		
Surplus notes	1,400,000		(5)
Gross paid-in and contributed surplus	1,300,000		
Unassigned funds (surplus)	<u>3,637,025</u>		
Surplus as regards policyholders		<u>7,837,025</u>	
Total liabilities, surplus and other funds		<u>\$ 49,824,733</u>	

Underwriting and Investment Exhibit
for the Year Ended December, 2002

Statement of Income

Underwriting Income

Premiums earned		\$ 77,583,594
Deductions:		
Losses incurred	\$ 53,947,509	
Loss expenses incurred	5,937,345	
Other underwriting expenses incurred	<u>20,590,825</u>	
Total underwriting deductions		<u>80,475,679</u>
Net underwriting loss		(2,892,085)

Investment Income

Net investment income earned	\$ 170,723	
Net realized capital losses	<u>(468,100)</u>	
Net investment loss		<u>(297,377)</u>
Net loss before federal income taxes		(3,189,462)
Federal income taxes incurred		<u>366</u>
Net loss		<u>\$ (3,189,828)</u>

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2001		\$ 18,364,667
Net loss	\$ (3,189,828)	
Net unrealized capital losses	(10,378,733)	
Change in surplus notes	1,400,000	
Aggregate write-ins for gains in surplus	<u>1,640,919</u>	
Change in surplus as regards policyholders		<u>(10,527,642)</u>
Surplus as regards policyholders, December 31, 2002		<u>\$ 7,837,025</u>

Reconciliation of Surplus as Regards Policyholders
from December 31, 1998 through December 31, 2002

Surplus as regards policyholders, December 31, 1998,
per Examination \$ 33,622,683

	<u>Gain in Surplus</u>	<u>Loss in Surplus</u>
Net losses	\$	\$ 2,674,292
Net unrealized capital losses		26,210,105
Surplus adjustments: Paid-in (Surplus note)	1,400,000	
Dividends to stockholders		1,000,000
Extraordinary amounts of taxes in prior years	1,057,820	
Aggregate write-ins for gains in surplus	<u>1,640,919</u>	
Totals	<u>\$ 4,098,739</u>	<u>\$ 29,884,397</u>
Net decrease in surplus as regards policyholders		<u>(25,785,658)</u>
Surplus as regards policyholders, December 31, 2002, per Examination		<u>\$ 7,837,025</u>

COMMENTS ON FINANCIAL STATEMENT ITEMS

- (1) Bonds
- (1) Preferred and Common Stocks
- (1) Cash on Deposit and Short-Term Investments

The Company's investment portfolio has historically been heavily invested in common stocks. With the sharp market decline in recent years, the Company's investment portfolio has been adversely affected. During the examination period, the Company's market value of its common stock portfolio decreased by approximately \$26 million. For the year ended December 31, 2002, the Company's net unrealized capital losses totaled \$10.3 million.

The California Department of Insurance (CDI), pursuant to California Insurance Code Section (CIC) 733(g), retained independent investment specialists for the purpose of performing a review of the Company's investment portfolio. The specialists concluded that the Company should re-balance its investment portfolio, and divest itself of many of its common stock equities. Based on the findings of the investment specialists, the CDI advised the Company to reduce its common stock holdings to a market value of \$5 million by March 13, 2003. In addition, the CDI advised the Company that its long term goal will be that the Company's common stock holdings be not more than 25% of policyholder surplus. During March 2003, the Company reduced its common stock holdings to a market value of \$5.3 million. However, as of December 31, 2003, the Company still had not reached the stated \$5 million market value common stock advisement, as its common stock portfolio was reported at a cost basis of \$10.2 million and a market value of \$8.4 million. The increase in market value was partially due to investment gains, coupled with the Company's purchase of additional common stocks. It is recommended that the Company reduce its common stock holdings to not more than 25% of surplus as regards policyholders.

Other deficiencies regarding the Company's invested assets included:

- The Company has a common stock holding that exceeds the excess funds investment limits pursuant to CIC Section 1196. It is recommended that the Company correct this deficiency;
- The Company does not have an approved custodian agreement. It is recommended that the Company obtain a custodian agreement that complies

with the guidelines set forth by CIC Section 1104.9. It should be noted that this recommendation was made in the previous examination;

- There are no procedures in place to identify unclaimed property, such as outstanding drafts or uncashed checks, nor does the Company escheat unclaimed property to the State of California. It is recommended that the Company implement unclaimed property law procedures, and escheat unclaimed property to the State of California. It should be noted that this recommendation was made in the previous examination. Since 1992, the Company has continued to disregard this recommendation from the CDI;
- The Company does not have investment guidelines. It is recommended that the Company adopt formal investment guidelines.

(2) Premiums and Agents' Balances in Course of Collection

Under a management agreement, H&H Agency, Inc. collects premiums for the Company, and holds the funds in a fiduciary capacity in financial institutions. Pursuant to its management agreement, H&H shall remit these funds due Sterling on a monthly basis. A review of the trust accounts disclosed that H&H was not remitting funds in accordance with the terms of the management agreement. It is recommended that H&H remit the premium funds to the Company on a monthly basis, as stated in its management agreement.

In contrast to the customary practice of initially booking full term premiums, the Company maintains the practice of recording premiums on a monthly basis. The Company has demonstrated that the inherently high cancellation rate of its book of business results in a significant disparity between the periods of risk and contract term. As a consequence of such, the Company has represented the booking of full term premiums would result in a distortion of its financial statements. Although the Company's methodology is not in strict conformity with the applicable SSAP, it does provide for the conceptual function of unearned premiums by recognizing of premiums over the policy period.

- (3) Federal Income Tax Recoverable
- (3) Receivable from Parent, Subsidiaries, and Affiliates

Federal income tax refunds due the Company have been deposited into cash accounts of H&H Agency, Inc., and not forwarded to the Company in a timely manner, as required by its consolidated tax allocation agreement. The Company has reported amounts as a receivable from its parent in excess of 90 days. Pursuant to its tax allocation agreement, it is recommended that H&H forward all tax refunds due the Company in a timely manner.

- (4) Losses and Loss Adjustment Expenses

The CDI, pursuant to CIC Section 733(g), retained an independent actuary for the purpose of providing a full actuarial evaluation of the Company's loss and loss adjustment expense reserves as of December 31, 2002. Based on this evaluation and further review by a Casualty Actuary from the CDI, the Company's December 31, 2002 reserves for losses and loss adjustment expenses were determined to be reasonably stated and have been accepted for purposes of this examination.

- (5) Surplus Note

On November 25, 2002, the Company issued a Certificate of Contribution in the amount of \$1.4 million, to Beverly K. Horaney, spouse of the ultimate controlling person, Shibley H. Horaney. Payment of the principal and interest of the certificate can only be made upon approval in writing by the California Insurance Commissioner.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Management and Control – Operating Lease (Page 5): It is recommended that the Company file for a California Insurance Code (CIC) Section 1101 exemption.

Corporate Records (Page 8): It is recommended that the Company comply with the provisions of CIC Section 735.

Accounts and Records (Page 11): The following recommendations have been made:

- It is recommended that the Company maintain sufficient accounting records to prove its premium trust position;
- It is recommended that H&H Agency, Inc., (H&H) transfer funds to the Company, based on the provisions of its management agreement, and not apply the philosophy of transferring funds on an “as needed” basis;
- It is recommended that the Company’s affiliate, Dashers Insurance Services, Inc. improve accounting controls for the maintenance of its local branch trust accounts;
- It is recommended that the Company obtain detailed policy data from its producer, Freedom National Insurance Services, Inc.;
- It is recommended that the Company strengthen its accounting controls in tracking policy counts for all of its producers.

Comments on Financial Statement Items – Bonds, Preferred and Common Stocks, and Cash on Deposit and Short-Term Investments (Page 16): It is recommended that the Company obtain a qualified custodian agreement that complies with the guidelines set forth in CIC Section 1104.9.

Comments on Financial Statement Items – Bonds, Preferred and Common Stocks, and Cash on Deposit and Short-Term Investments (Page 16): It is recommended that the Company implement unclaimed property law procedures and escheat unclaimed property to the State of California.

Comments on Financial Statement Items – Bonds, Preferred and Common Stocks, and Cash on Deposit and Short-term Investments (Page 16): It is recommended that the Company adopt formal investment guidelines.

Comments on Financial Statement Items – Premiums and Agents’ Balances in Course of Collection (Page 17): It is recommended that H&H remit premium trust funds in accordance with the terms of the management agreement.

Comments on Financial Statement Items – Federal Income Tax Recoverable and Receivable from Parent (Page 18): It is recommended that all tax refunds be forwarded to the Company in a timely manner pursuant to its consolidated tax allocation agreement.

Previous Report of Examination

Management and Control – Operating Lease (Page 3): It is recommended that the Company file for an exemption pursuant CIC Section 1101. The Company did not comply with this recommendation.

Management and Control - Management Agreements (Page 3): It is recommended that the Company obtain an independent financial examination of H&H as required under CIC Section 769.84. It has been determined that the Company is not subject to this Code provision.

Comments on Financial Statements – Bonds (Page 12): It is recommended that the Company submit its investments to the SVO for valuation. Due to a change in reporting requirements, this is no longer required. In addition, it is recommended that the Company obtain a custodian agreement that complies with the guidelines set forth by CIC Section 1104.9. The Company continues to not have a custodial agreement.

Comments on Financial Statements – Cash on Deposit (Page 12): The Company did not comply with the escheat and unclaimed property recommendation.

ACKNOWLEDGEMENT

The courtesy and cooperation extended by the Company's officers and employees during the course of this examination are hereby acknowledged.

Respectfully submitted,

Edward W. Aros, Jr.
Examiner-In-Charge
Associate Insurance Examiner
Department of Insurance
State of California